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SUBJECT: SHANGHAI STOCK EXCHANGE: RECENT VOLATILITY, PROSPECTS FOR

REFORM

REF: Shanghai 100; Shanghai 28 and previous

¶1. (SBU) Summary. Shanghai financial services industry participants identify last year's stock market bubble as the primary source of the Shanghai Stock Exchange's most recent volatility. Poor economic performance in certain sectors has also fueled volatility, with inflation and softening real estate markets as well as export challenges emerging as key concerns for investors. Government intervention to shore up the Shanghai Stock Exchange - the index is down almost 50 percent since January 1 - is seen as unlikely, with our interlocutors noting a lack of large-scale social unrest and regulator deadlock.

¶2. (SBU) Summary cont'd. Our interlocutors also note the Shanghai stock market may be approaching its bottom, making this an opportune time to continue non-tradable share reform and introduce new financial products and services. They express skepticism about whether these reforms will be enacted, however. Nevertheless, our interlocutors are generally positive about the stock market's future, noting that corporate non-financial earnings appear to be remaining strong. They also note that the lack of investor protests in the stock market as well as the ability of firms to weather the market's recent downturn could be a sign that the Shanghai stock market is becoming more mature. End summary.

Introduction

¶3. (SBU) In meetings from June 20-24, Congen Econoffs met with Shanghai financial industry participants to discuss recent volatility in the Shanghai Stock Exchange (SSE). Meeting participants included an American financial consultant based in Shanghai, the general manager of a U.S. joint venture securities firm, Haitong Securities Macro Economic Analyst Wu Yiping, Shanghai Municipal Government Financial Services Office Director-General Fang Xinghai, and SSE Global Business Development Deputy Chief Chao Kejian.

Background

¶4. (U) From June 10 through close of trading on June 27, the SSE has fallen 17.5%. Trading during the shortened week of June 10-13 (markets were closed on June 9 for a national holiday) was especially volatile, with the Shanghai Composite Index (SCI)

falling 13.8% to 2869 points. On June 27, the SCI fell to 2748 points, its lowest level since the middle of March 2007. The initial June 10 downturn was sparked by a 1% increase in required reserve rates (RRR), bringing that rate up from 16.5% to 17.5%. That RRR increase was announced on Saturday, June 7, and on June 10 (first trading day thereafter) the SCI fell 7.73% to 3072 points. Volatility has since continued, largely driven, according to these interlocutors, by rising fuel prices, softening real estate markets, inflation expectations and prosecution of former China Security Regulatory Commission (CSRC) Vice-Chairman Wang Yi.

Immediate and Long-Term Sources of the Markets Recent Downturn

¶5. (SBU) While June's downturn was set in motion by the PBOC's RRR hike of June 7, the larger decline since the beginning of the year has several sources. According to Fang and Chao, the largest source was last year's speculation, which created a bubble in the stock market. At its peak, P/E ratios reached over 60, an unsustainable level according to many analysts. Questions also remain over stock market corruption. Financial news outlet Caijing reported on June 11 that former CSRC Vice-Chairman Wang Yi had been detained while under investigation for insider trading and violation of security regulations. Chao and the JV manager noted this and rumors of investigations into low and mid-level officials had been fueling stock market volatility because retail investors see such developments as introduction of additional uncertainties about market operations. Fang on the other hand believes investors have become sufficiently accustomed to the occasional regulatory corruption case that such rumors no longer cause much concern. All concurred that whatever the short-term impact on investor outlook, investigation and prosecution of such cases in the longer term will be good for investors' confidence and for the

market.

¶6. (SBU) Our interlocutors also noted larger then expected inflation had cooled markets. Inflation has changed investors' expectations in two ways: first, by compressing corporate profit margins with rising costs; and second, by the credit crunch resulting from the government's attempts to control inflation. The JV manager notes the first was partially mitigated using price controls, especially for energy, although some fuel prices were significantly increased in mid-June. Keeping prices artificially low, however, distorted the market by encouraging over consumption and under production. This led to fuel shortages throughout the country, which also compressed corporate earnings, though through a combination of mandating and subsidized production, near term costs were lower then they would have been had the market been allowed to equilibrate, according to the JV manager. Both he and Chao note that the energy price increases announced in mid-June helped bring the market closer to equilibrium, improving the long-term outlook, but also increased costs for downstream firms in the near-term.

¶7. (SBU) Inflation also led to government attempts to contract liquidity. The JV manager noted the current credit crunch has made it difficult for real estate developers to find financing in a time when the industry is already struggling due to falling prices. Nevertheless, Fang, Chao and Wu believe the real estate sector will be sufficiently buoyed by demand. The JV manager and the financial consultant also believe that the government will not allow real estate prices to fall too far, especially in Beijing and Shanghai, because of large real estate exposure by the major banks. Both Wu and the JV manager, however, suggest that real estate in southern China may continue to cool, arguing that the recent appreciation of residential prices had been most significant there.

Prospects and Expectations for Policy Intervention in the Shanghai Stock Exchange

¶8. (SBU) Prior to the market's fall since June 10, investors and the media had predicted the government would not allow the

SCI to fall below 3,000. A previous reduction of the stamp tax the last time markets fell below 3,000 reinforced this belief. To date, however, no such intervention has occurred. Our interlocutors were mixed on investor expectations of policy intervention. Both Fang and Chao believed the government will have to do something. This, they claim, is necessary to satisfy retail investors who lost money in the market's most recent downturn. The JV manager, however, does not believe investors are expecting intervention. He notes a recent survey in which only 20% of retail investors said they expected the government to intervene. The financial consultant echoed this view, saying he believed investor expectations of intervention have been decreasing with each passing day since June 10's downturn.

¶9. (SBU) Our interlocutors also expressed uncertainty about what form intervention would take, if indeed intervention is undertaken. The financial consultant and JV manager expressed skepticism regarding adjustment of the stamp tax or increasing QFII quotas. The JV manager noted last time the government increased QFII quotas to support stock prices they were criticized for letting foreigners buy into a cheap market, and now the market is even cheaper. Both also questioned the efficacy of a tracker fund similar to the one used in Hong Kong to help stabilize the market. The idea for using a tracker fund in Shanghai has been discussed in the media as a means to help stabilize the market's most recent volatility. The financial consultant noted that the SSE is becoming more institutionalized, with institutional investors helping to stabilize the market. The JV manager also noted the market may be near the end of its adjustment, thus eliminating the need for such a fund in stabilizing recent volatility. Other policy options the government may be considering include restricting new IPOs, slowing non-tradable share reform, allowing margin trading or launching stock index futures.

¶10. (SBU) Regardless of investor expectations, our interlocutors expressed various opinions on what might spur or

prevent government intervention. Financial Services Office DG Fang admitted that only limited protests had occurred so far, but felt the government is still under pressure by investors to take action to support the stock market. SSE's Chao expressed similar sentiments, noting that investor pressure would eventually lead to intervention. The JV manager disagreed, saying protests over the most recent downturn had not reached the level they had when the government intervened last time. Without more pressure from investors, he predicts the government will not intervene. He notes Vice Premier Wang Qishan (in charge of financial and economic issues) said this spring that the government will not intervene unless there is social disturbance. The financial consultant, however, believes government intervention is unlikely because there is no one willing to take charge of not only rescuing the stock market, but the economy in general. He notes that any official who takes charge will be held responsible if measures prove ineffective in halting or reversing the recent downturn.

Investors Expectations of Market Performance

¶11. (SBU) Absent intervention, our interlocutors asserted that retail investors are becoming increasingly pessimistic about the stock investment climate. The financial consultant noted recent natural disasters, inflation and the U.S. economic slowdown as contributing to a general pessimism among investors. This view was echoed by Fang at the Financial Services Office, who noted that the stock market will follow the economy. He predicted that as long as there is strong economic growth and inflation is controlled, the stock market will recover and even do well. SSE's Chao believes that investors are waiting for inflation to decline before returning to the market with new purchases.

¶12. (SBU) The market's fall has also shaped investor expectations regarding where the market's bottom might be. As previously noted, many thought the SCI bottom would be around 3,000 due to expected government intervention at that level.

Our interlocutors noted the difficulty of predicting where the new bottom might be, but 2,500 came up repeatedly as a best guess. Both Haitong Securities' Wu and the JV manager noted that at the SCI 2500 level, the P/E ratio would be near 17, about the same level as for markets in developed countries. SSE's Chao also noted he had spoken with foreign institutional investors who had signaled they would begin investing again when the market reached 2,500.

¶13. (SBU) Despite the downturn and poor performance in some sectors, Chao, Fang and the financial consultant remain optimistic about the market's performance. Chao and the financial consultant noted that while a substantial portion of the earnings of several companies came from financial investments last year, earnings for many companies did not. Chao notes that for many listed companies, performance is actually better this year than it was last. The financial consultant notes that in such an environment, speculators are taking the greatest losses while fund managers are doing considerably better. The U.S. JV manager is not so optimistic, however. He notes that corporate profit margins are still being squeezed by rising costs. He notes that even upstream industries such as coal and aluminum are suffering, mostly due to higher energy prices.

Stock Market Downturn Presents Opportunity for Reform though Regulators Remain Reticent

¶14. (SBU) Several of our interlocutors noted the market's recent downturn may present an opportunity for equity market reform. The JV manager, the financial consultant, Fang, Wu and Chao noted that the markets current level may make it easier for non-tradable share reform to proceed by making it easier to absorb additional shares. They agreed that because most holders of non-tradable shares acquired them at negligible prices, they will immediately sell when given the chance, driving down prices. Given that many investors now see the market as relatively cheap, and the relative paucity of good investments in China's increasingly bearish markets, they believe the market is now more ready to absorb newly tradable shares without

significantly affecting current share prices. Fang, Wu and Chao made similar arguments regarding the supply of new shares from IPOs, noting that the China Securities Regulatory Commission could delay the dates of IPOs.

¶15. (SBU) In addition to share reforms, the recent downturn may point to the need for additional financial products. Fang and Chao noted that introducing index futures and short selling would allow investors to better hedge against risk, making the markets less volatile. Chao, Fang, the JV manager and the financial consultant emphasized the need for broader margin trading as well, though they acknowledged the systemic risk this may introduce and its role in the stock market's fall in 2001. Fang noted that the absence of leverage this time may have contributed to the lack of protests over this market downturn, since individual retail investors' downside risks were smaller in the absence of leverage.

¶16. (SBU) Prospects for these reforms are mixed. The financial consultant said index futures are ready for launch, but government regulators are reluctant to launch new financial products for fear that they could be held responsible by the investing public if introduction coincides with a further decline in the market. DG Fang similarly opined that China's financial services regulators are risk averse. Fang and the SSE's Chao also noted a current SSE controversy over warrants, the trading conditions for which some retail investors have claimed were biased against small investors. They both believe warrants will no longer be allowed at the SSE, and that the controversy may only reinforce regulators' caution about introduction of new financial products. Still, the JV manager speculated the CSRC is probably under pressure from the SSE and the Shanghai Municipal Government to introduce new products in pursuit of the city's goal of becoming an international

financial services center. Chao and Fang, our interlocutors from the SSE and the Shanghai Government respectively, are indeed enthusiastic about the launch of new financial products.

Real Economic Impact of Shanghai Stock Market Downturn Remains Limited

¶17. (SBU) Though the SSE market downturn has been substantial, our interlocutors are quick to emphasize that the impact on the real economy has been and will be limited. China remains a magnet for foreign direct investment (and hot money) and China's trade surplus remains large.   The SCI decline's impact may be most apparent in lowering demand for luxury goods, DG Fang allowed. The JV manager echoed this view, saying he expected auto sales in particular to decline. He predicts that Shanghai auto dealership sales in May and June may decline 30 percent from the April volume. SSE Research Department's Fu Hao, with whom we met in late May, highlighted that most companies in China still rely on bank loans and retained earnings rather than the stock market to raise capital. Fu also noted that most investment in the stock market is surplus savings, income earned beyond what one had initially planned to consume and to save. The market downturn, by our interlocutors' analyses, will therefore not significantly affect consumer confidence outside of luxury goods.

Investor's Reaction to Market Downturn Could Signal a More Mature Market

¶18. (SBU) Despite the market's recent downturn and volatility, our interlocutors remain optimistic about the market's future. DG Fang noted that in the recent downturn, fewer firms went under, a sign that listed companies have stronger fundamentals then they had in previous downturns. He also notes that fewer protests could be a sign that investors, especially retail investors, are beginning to better understand the risks associated with the stock market. The financial consultant and JV manager expressed similar optimism that the SSE is showing signs of becoming a more mature market through the travails it is now enduring.
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